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Creating a climate of change digest

Climate risk regulatory developments in the financial services industry

Leading off

Federal Insurance Office (FIO) publishes landmark report on gaps in insurance oversight of climate risk

The FIO, a unit of the US Department of the Treasury (Treasury) published a long-awaited report on climate risk oversight in the insurance industry as part of an ongoing effort by the Biden administration to combat the climate crisis with action from the federal government.[1] Treasury's almost 13-year-old office dedicated to monitoring the US insurance system stressed that the US insurance industry is challenged by increasing financial risks due to the worsening effects of climate change, most recent aspects of which it catalogued in detail.[2]

National Association of Insurance Commissioners (NAIC) states need to enhance their responses soon

The FIO's report noted, for example, that Hurricane Ian was one of 18 climate-related disasters in the United States in 2022 that each cost more than $1 billion.[3] Additionally, the report stated that nine of the 10 costliest US hurricanes have occurred since 2005, and eight of the 10 costliest US wildfires have occurred since 2017, after adjusting for inflation.

Although the FIO recognized the impact throughout the insurance sector, from investments to mortality-dependent lines, it gave the lion's share of its attention to property and casualty (P&C) insurance issues. These issues include coverage for vulnerable populations and the intertwining of the property markets with the consumer lending sector. The FIO unveiled the report with climate-risk warnings and a call to action, in remarks by a senior Treasury official during a Brookings Institution event, to underscore the importance of its study.[4]

The report commented on the state insurance regulatory regime in its efforts to incorporate climate-related risks into regulation and supervision. While praising the substantial, ongoing, recent work of the states and the NAIC, the FIO called for more action in the next several years, characterizing these efforts as "nascent".[5]

It is important for "both insurers and regulators to consider the extent and potential significance of insurers' exposure to climate-related transition risks," the FIO stated in its report, citing the trillions of dollars that insurers own in invested assets in the United States.[6]

FIO offers 20 robust and detailed recommendations to the states and the NAIC

The FIO's 20 recommendations, related to climate risk, cover a scope of action that includes:

- **Analysis of US climate-related insurance supervision and regulation**—expand work on climate-related risk and promote uniformity; and, encourage the capturing of more granular data.
- **Prudential supervision and regulation**—the adoption of state regulatory guidance to monitor climate risk with a focus on strategy and financial planning; incorporate climate risk into the financial analysis handbook and examinations along with associated training; consider changes in risk-based capital (RBC) charges that relate to climate risks; add climate risk to the ORSA guidance manual and reports; refine capabilities of the Catastrophe Model Center of Excellence; and, scenario analysis work should be prioritized.
- **Macroprudential supervision and regulation**—climate-related risks should be included in macroprudential risk assessments, and include assessment of underwriting and investments; monitor reinsurance capacity; add to supervisory college discussions; work with stakeholders to quantify impact on state guaranty funds and downstream exposures; and, monitor residual and surplus lines markets.
- **Market conduct supervision and regulation**—regulatory stakeholders should work together to improve consumer education, conduct more post-disaster surveys, support the claims process, and review of insurer fulfillment of obligations.
- **Disclosure initiatives**—Climate Risk and Disclosure Survey (CRDS) improvements should achieve broad state adoption; monitor responses and provide an annual review of results; consider updating and revising the CRDS.[7]
- The NAIC responded to the report by noting that much of the work suggested by the FIO was already underway and supported by its Climate Risk & Resiliency Task Force.[8] "As [the] FIO indicates in its new report, the states, the NAIC, and [the] FIO all have important roles to play in helping address climate-related risks in the insurance industry," stated NAIC President and Missouri Insurance Director Chlora Lindley-Myers.[9]

FIO is gearing up for more action

The FIO raised its intentions to proceed with its proposed collection of nationwide underwriting and policy data from P&C insurers regarding current and historical homeowners insurance underwriting.[10]

The ZIP code-level data collection request, as envisioned by the FIO in October 2022, was initially expected to help the FIO assess the effects on insurance availability for policyholders, including whether climate change may create the potential for any major disruptions of private insurance coverage in regions of the country that are particularly vulnerable to climate change impacts.

The FIO is also undertaking an analysis of the nearly $7 trillion in net admitted invested assets owned by insurers in relation to potential exposure to climate-related transition risks, it said, citing concerns over potential future defaults or impairments.

"The first nationwide analysis of insurers' transition exposures, risks, and opportunities will build upon prior work of state insurance regulators such as New York's Department of Financial Services and the California Department of Insurance," the FIO said, in one of multiple instances where it cited the climate-related contributions of state insurance departments.

Federal Reserve Bank of New York (New York Fed) analyzes and measures scenario-related life and P&C insurers' transition, and physical climate risk

The climate-related transition risk of life insurers in the United States rose significantly in a recent stress scenario, while the physical climate risk for P&C insurers showed no sign of potential systemic undercapitalization, according to a new staff report by the New York Fed.[11]

The report, measuring the climate risk exposure of insurers, used a climate stress scenario framework to measure the climate risk exposure of life and P&C insurance companies in the United States. The report's main output is insurers' expected capital shortfall (a measure known as CRISK), focusing on life insurers' transition risk with their financial assets of $9.4 trillion and P&C insurers' physical risk with their assets of $3 trillion.[12] "The top ten P&C insurers' CRISKs have mostly been negative, suggesting no sign of potential systemic undercapitalization," the New York Fed's paper assured. As of the end of 2020, the aggregate marginal CRISK (mCRISK), the expected capital shortfall solely attributed to climate stress, was $20 billion, representing 8% of the top 10 P&C insurers' market capitalization.[13]

Specifically, the notable increase in transition risk for life insurers in the United States was modeled for the 2019–2020 collapse of fossil fuel prices and found that the aggregate transition CRISK for life insurers in the United States also significantly rose by more than $150 billion, which represents about 28% of their market capitalization, according to the New York Fed. The paper said that life insurers' mCRISK increased more than $85 billion during the same 2019–2020 period. The authors compared that figure to banks and said that the size of the transition climate risk is similar, although the banks' numbers are larger and the insurers' are smaller because banks' balance sheets are larger.

The New York Fed report concluded that "transition risk can have a significant impact, while physical risk has a relatively lower impact on insurers' capital shortfall and risk sensitivities." The authors encouraged further research into examining insurers' policy pricing and policy volume actions taken to respond to various physical and transition climate shocks.

The New York Fed does not regulate insurers; however, similar to the approach taken by Treasury, the New York Fed is analyzing the sector risks affected by climate change.[14]

Commodity Futures Trading Commission's (CFTC) Enforcement Division looks to whistleblowers to further assist with identifying and reporting possible violations of the Commodity Exchange Act (CEA)

The CFTC Whistleblower Office, which is part of the agency's Division of Enforcement, recently communicated its intent to collaborate with market participants that provide information on a range of fraudulent or otherwise manipulative activities occurring in the carbon markets. The agency suggests that "information from whistleblowers advances the Commission's enforcement mission and, in turn, further builds integrity and trust in the carbon markets by rooting out fraud and manipulation" and is encouraging the reporting of activities including:

- Manipulative and wash trading
- "Ghost" credits
- Double counting
- Fraudulent statements relating to material terms of the carbon credits
- Potential manipulation of tokenized carbon markets[15]

The CFTC is aware of possible consequences of whistleblowing and has established "confidentiality and anti-retaliation protections," in its existing Whistleblower Program that was created under Section 748 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*.[16] These protections complement those included in the CEA related to confidentiality and anti-retaliation. In addition to offering protection to whistleblowers, the CFTC may provide financial rewards when information received results in (i) the Enforcement Division's execution of an enforcement action or (ii) other regulatory agencies taking enforcement-related action, provided that specified criteria are met.

Over the past nine years, the CFTC has paid out roughly $300 million to whistleblowers for providing information that led to the imposition of more than $3 billion in sanctions.[17] In his recent remarks, the CFTC's Division of Enforcement Director Ian McGinley stated that, "as carbon credit markets continue to grow, we will act to foster the integrity of these markets by fighting fraud and manipulation."[18] Director McGinley also voiced the agency's commitment to following up on plausible leads and recognized the importance of whistleblowers in the protection of carbon markets.

International Financial Reporting Standards (IFRS®) Foundation staff confirm consistency between IFRS S2 Climate-related disclosures and the Task Force on Climate-related Financial Disclosures (TCFD) recommendations

The IFRS recently issued a side-by-side comparison of key requirements and guidelines for application outlined in IFRS S2 *Climate-related Disclosures* (IFRS S2) and fundamental elements of the TCFD's final report, *Recommendations of the Task Force on Climate-related Financial Disclosures* (the TCFD recommendations).[19] While IFRS S1 *General Requirements for Disclosure of Sustainability-related Financial Information* (IFRS S1) and IFRS S2 are collectively considered by the IFRS to "fully incorporate the recommendations of the TCFD," the comparison reflects three types of differences primarily noted concerning IFRS S2, which are further detailed in table 1.[20] Specifically, the comparison suggests that "IFRS S2:

- uses **different wording** to capture the same information as the TCFD recommendations. In other words, in these cases, the requirements in IFRS S2 are described as being broadly consistent with the TCFD recommendations;
- requires **more detailed** information that is in line with the TCFD recommendations; and
- **differs** from the TCFD *guidance*—but not from the TCFD overall recommendations—mainly by providing some **additional** requirements and guidance."[21]

Table 1. Comparative summary of TCFD recommendations and IFRS S2 requirements

	TCFD recommendations, recommended disclosures, and guidance	IFRS S2 *Climate-related Disclosures*
Governance	"Disclose the organization's governance around climate-related risks and opportunities."	"Understand the governance processes, controls, and procedures used to monitor, manage, and oversee climate-related risks and opportunities."
Strategy	"Disclose the actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning where such information is material."	"Understand a company's strategy for managing climate-related risks and opportunities."
Risk management	"Disclose how the organization identifies, assesses, and manages climate-related risks."	"Understand the processes to identify, assess, prioritize, and monitor climate-related risks and opportunities, including whether and how those processes are integrated into and inform the company's overall risk management process."
Metrics and targets	"Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material."	"Understand a company's performance in relation to its climate-related risks and opportunities, including progress towards any climate-related targets it has set, and any targets it is required to meet by law or regulation."

Source: IFRS, "Comparison: IFRS S2 *Climate-related Disclosures* with the TCFD recommendations," July 2023.

Upon the issuance of IFRS S1 and IFRS S2, the Financial Stability Board (FSB) deems the work of the TCFD to be complete based on the Task Force's progress to further reduce the lack of coordination between various sustainability reporting initiatives.[22] Now, companies that adhere to the requirements in IFRS S1 and IFRS S2 will be in alignment with the TCFD recommendations, as the recommendations are fully integrated with the International Sustainability Standards Board (ISSB) Standards.[23] Given the current level of consistency between existing standards and recommendations, the FSB—the body that formed the TCFD in 2015—suggested that the IFRS assume ongoing responsibility for the monitoring and analysis of companies' climate-related disclosures.

FSB provides its latest update on the FSB Roadmap for addressing Climate-related financial risks

Since the development of the initial FSB roadmap in 2021, the body has published periodic progress reports focused on four aspects of climate-related policy: firm-level disclosures, data, vulnerabilities analysis, and regulatory and supervisory practices and tools.[24] Potential threats to financial stability, posed by climate-related financial risk (both physical and transition risks) has seen increased regulatory interest over time, especially against the backdrop of changing fiscal and economic conditions.

The most recent roadmap update communicates progress across jurisdictions as compared to the overarching goals as seen in table 2.[25]

Table 2. Summary of current-term FSB progress compared to key goals

Building block	Goal	Summary of progress
Disclosures	"Achieve globally consistent, comparable, and decision-useful public disclosures by firms of their climate-related financial risks."	• Publication of IFRS S1 and IFRS S2 promote enhanced consistency in disclosures. • The ISSB is expected to assume monitoring of firms' implementation of climate-related disclosure standards and recommendations.
Data	"Establish a basis of comprehensive, consistent, and comparable data for monitoring climate-related financial risks globally."	• Ongoing work to improve the "availability, quality and cross-border comparability of climate data."
Vulnerability analysis	"To more systematically assess and better understand climate-related financial vulnerabilities and potential financial stability impacts."	• Ongoing incorporation of "climate-related risk into risk management and prudential frameworks."
Regulatory and supervisory practices and tools	"Establish effective and, where useful and appropriate, consistent supervisory and regulatory approaches and tools to address climate-related risks, both within individual sectors and at the system-wide level."	• Establishing a team to form a view on the importance of transition plans and transition planning across firms related to financial stability.

Source: Financial Stability Board (FSB), *FSB roadmap for addressing financial risks from climate change: 2023 progress report*, July 13, 2023.

In terms of next steps, the FSB is looking to establish a level of interoperability that would assist with the prevention of "double reporting" disclosure information and standing up an international assurance program that would improve disclosure reliability. The FSB is also interested in global data storage solutions and the eventual development of climate-related risk metrics.[26] Understanding the impact of climate-related shocks across jurisdictional boundaries and between industries is one of the FSB's future focal points along with maintaining effective communication and coordination between regulatory, supervisory, standard setting, and other bodies.

Treasury appoints a new climate counselor to advise the Treasury Secretary on climate-related matters

Going forward, Treasury Secretary Janet L. Yellen will receive counsel from recently appointed Ethan Zindler, who assumes his position at the helm of Treasury's Climate Hub.[27] In the position, Zindler is responsible for advancing Treasury's implementation of strategic climate-related policy initiatives and working toward stemming the threat of climate change using financially driven risk mitigation techniques. Zindler will also oversee Treasury's plans concerning the path to net-zero domestic and international economies.

Secretary Yellen stated, "Ethan [Zindler] will bring analytical rigor and decades of experience in the climate space to this role and to the Treasury Department, and he will build on the Climate Hub's strong track record of results."[28] Based on the Secretary's remarks, Zindler's expertise will be utilized as Treasury moves forward with carrying out the Inflation Reduction Act and other efforts. In her remarks, Secretary Yellen reiterated her stance on the importance of addressing climate change. Treasury's Climate Hub has been playing an instrumental role in the implementation of the Inflation Reduction Act and creating an inclusive clean energy economy.

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Additional Deloitte US perspective on climate risks

For additional insights, please see our ongoing series on how climate risks are shaping US financial regulatory initiatives and the impact these developments may have on the financial services industry and the broader economy:

- Deloitte 2023 *CxO Sustainability Report*
- 2023 financial services industry outlooks
- Ingraining sustainability in the next era of ESG investing
- The CIO's call to action: Driving an environmentally sustainable tech agenda to accelerate organizational change
- Climate Change and Financial Risk Digest | Deloitte US
- Center for Regulatory Strategy - Sustainability, climate & equity | Deloitte US

Endnotes

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